Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CLE:TL-N-7904-98
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to: Examination Division
Attn: Charlie Britten E:EB:2 Independence
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from: Associate District Counsel, Ohio District
Cleveland, Ohio

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subject: [redacted]/**Change of Method of Accounting Issue**
U.I.L. No. 446.11-02

This responds to your request for advice regarding whether [redacted] changed its method of accounting for [redacted] development costs beginning in [redacted]. Our advice is provided without prior coordination with the Office of Chief Counsel, pursuant to the 10-Day Post Review procedures of CCDM (35)3(19)4(4), as this issue involves primarily well-settled principles of law. We are required, however, to forward a copy of this memorandum to both the Assistant Chief Counsel (Field Service) and the Northeast Regional Office for review. Within 10 days after receipt, the Associate Chief Counsel is to advise this office as to whether it: 1) concurs with our opinion; 2) believes some modification is appropriate; or 3) needs additional information or time to evaluate our opinion. We will inform you of their response as soon as it is received.

Disclosure Statement

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Issue

Whether [redacted] changed its method of accounting for [redacted] development costs beginning in [redacted] or was the change in treatment of such costs merely a consequence of a change in underlying facts.

Conclusion

[redacted]'s method of accounting for [redacted] development costs prior to [redacted], regardless of the size of the project, was to capitalize/amortize all costs. As such, absent permission to change its method of accounting, [redacted] was likewise obligated to capitalize/amortize [redacted] development expenditures incurred after [redacted]. Clearly, [redacted] applied a new method of accounting for [redacted] development projects in [redacted] when it began to expense costs incurred in connection with such projects as incurred. [redacted]'s "change in underlying facts" argument thus appears to be that the [redacted] activities undertaken by [redacted] in [redacted] were fundamentally different from those undertaken by it prior to [redacted], such that the [redacted] activities constituted a new "item" for purposes of section 446, for which [redacted] was free to select a method of accounting for this allegedly "new " item (in this case, immediate deduction). However, [redacted]'s alleged "changed facts" are merely that, beginning in [redacted], [redacted] made a business decision to undertake a greater number of "major" [redacted] development projects and spent substantially more on such projects, as compared to [redacted]. Admittedly, we found no cases in which a court ruled directly on whether this would constitute a "change in underlying facts." However, we are nonetheless confident that a unilateral business decision to undertake more internal [redacted] development and to spend more thereon is not a "change of underlying facts," and does not distinguish the "new" [redacted] development as a new item for which the taxpayer is free to select method of accounting, without the prior consent of the Commissioner.

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[1] All section references hereinafter, unless otherwise indicated, are to the Internal Revenue Code as in effect during the years in issue.

Law

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(e) and section 1.446-1(e) of the income tax regulations require a taxpayer to obtain the advance consent of the Commissioner before changing the method of accounting used for tax purposes.

A method of accounting denotes not only the taxpayer's overall method of accounting, but also the accounting treatment of an item. Treas. Reg. Sec. 1.446-1(a)(1).

Section 1.446-1(e)(2)(ii)(a) of the regulations provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Section 1.446-1(e)(2)(ii)(a) further states that a change in method of accounting includes a change where the Code and regulations thereunder specifically require the taxpayer to obtain the prior consent of the Commissioner. Section 1.446-1(e)(2)(ii)(b) of the regulations provides that a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. Further, a change in method of accounting does not include a change in treatment resulting from a change in underlying facts, a correction of mathematical or posting errors, or errors in the computation of tax liability.

Section 174(a)(1) allows a taxpayer to elect to deduct research and experimental costs when incurred. Section 174(a)(3) deems this a method of accounting and prohibits changes without the consent of the Secretary.

Revenue Procedure 69-21, 1969-2 C.B. 303 provides guidelines to be used in connection with the examination of Federal income tax returns involving the costs of computer [redacted]. It holds that computer [redacted] development costs are so similar to section 174 costs as to be deductible in the same manner. Accordingly, the Service will not disturb a taxpayer's treatment of costs incurred in developing software where:

1. All of the costs properly attributable to the

development of [redacted] by the taxpayer are consistently treated as current expenses and deducted in full in accordance with rules similar to those applicable under section 174(a) of the Code; or

2. All of the costs properly attributable to the development of [redacted] by the taxpayer are consistently treated as capital expenditures that are recoverable through deductions for ratable amortization, in accordance with rules similar to those provided by section 174(b) of the Code and the regulations thereunder, over a period of five years from the date of completion of such development or over a shorter period where such costs are attributable to the development of [redacted] that the taxpayer clearly establishes has a useful life of less than five years.

> It allows a taxpayer either to deduct the [redacted] development costs when incurred or to capitalize and amortize them.

Section 3.01, Rev. Proc. 69-21.

Section 6.01 of Rev. Proc. 69-21 provides that the cost of development of [redacted] in accordance with the procedures therein will be treated as a method of accounting. Any change in the treatment of such costs is considered to be a change in method of accounting subject to the provisions of sections 446 and 481 and the regulations thereunder.

Section 1.174-3(a) of the regulations provides, in part, that if the method of currently expensing research and experimental expenditures is adopted it shall apply to all such expenditures paid or incurred in the taxable year of adoption and all subsequent taxable years, unless a different method is authorized by the Commissioner with respect to part or all of the expenditures.

Revenue Ruling 71-248, 1971-1 C.B. 55, states that a taxpayer who has elected under section 174 to deduct computer [redacted] development costs cannot change its election to capitalize and amortize those costs without the consent of the Commissioner.

Revenue Ruling 68-144, 1968-1 C.B. 85, holds that where a taxpayer had elected to currently expense all research and experimental expenditures, with the exception of those on particular projects to which the deferred expense method was elected, it cannot in a later year elect the deferred expense method on new projects unless permission is granted by the Commissioner.

Facts

Prior to tax year [redacted], [redacted] capitalized and amortized [redacted] development projects for both book and tax purposes. Beginning in [redacted], [redacted] expensed all [redacted] development costs as incurred for tax purposes - but not for book purposes. [redacted] reported a Schedule M-1 adjustment reflecting the difference between book and tax treatment of these costs beginning with its [redacted] tax return. It did not file a request for permission to change its method of accounting for [redacted] development costs with the Commissioner.

[redacted] and [redacted] merged on [redacted], and became part of the same affiliated group for consolidated returns purposes on that date. On [redacted], the internal [redacted] development function of [redacted] was transferred to [redacted]. Thereafter, the expensing of [redacted] development costs ceased and all new [redacted] development costs were capitalized and amortized for both book and tax purposes.

The examining agent has determined that [redacted] made an unauthorized change in its method of accounting for [redacted] development projects in [redacted]. The agent has proposed a section 481 adjustment of $[redacted] for tax year [redacted], with respect to the period of [redacted], through [redacted][2].

In response to the proposed adjustment, [redacted] provided a memorandum dated [redacted], in which it argues that the expensing of [redacted] development projects beginning in [redacted] was not an unauthorized change in method of accounting, but rather was a permissible consequence of a "change in underlying facts." See Treas. Reg. Sec. 1.446-1(e)(2)(ii)(b). The "changed facts," alleges [redacted], was that starting in [redacted], [redacted] began significantly increasing its level of internal [redacted] development. This increase was the result of a change in [redacted]'s business and operational focus. According to [redacted], with the exception of the development of [redacted] ([redacted]), [redacted] development activity

[2] It is our understanding that all of the tax years at issue, i.e. [redacted] through the short tax year ending with [redacted]'s merger with [redacted] in [redacted], are open. Normally, a section 481 adjustment is made in the earliest open year, and is made to eliminate duplications or omissions arising from prior closed years due to the change in accounting method. Given that under the facts of this case none of the affected years are open, it would not normally be necessary to rely on section 481 to address the effects of the change, i.e., the adjustments could be made in each of the affected open years pursuant to section 446. We are advised, however, that tax years [redacted] through [redacted] are part of a prior audit cycle which currently in Appeals, and due to administrative/non tax issues, it is preferable to account for the change in method as a section 481 adjustment in [redacted]. We are advised by the ISP for Accounting Method Changes while this approach may not be preferred, it is not incorrect for tax purposes.

prior to [redacted] was limited to minor modifications of installation processes and some sporadic conversion/consolidation activities.

The [redacted] memorandum provides a brief discussion of examples of [redacted]'s post-[redacted] development activities. [redacted] generally contends that these post-[redacted] development activities either addressed needs which were not addressed previously by existing [redacted] systems or represented improvements over existing information systems. These [redacted] developments contends [redacted] were the result of a change in the "... focus and strategic vision ...[which]... clearly represented a change in the underlying facts, necessitating a change in how [redacted] treated certain expenses incurred in the implementation of its strategies."

[redacted] also points to [redacted]'s significantly increased [redacted] development expenditures during [redacted] through [redacted] as support for its "change of underlying facts" argument. In particular, [redacted] alleges that [redacted]'s [redacted] development expenditures were [redacted]% greater than its [redacted] expenditures. For [redacted] and [redacted] expenditures purportedly increased by [redacted]% and [redacted]%, respectively. These increased expenditures, coupled with the increase in the complexity and functionality of the [redacted], represents a change in underlying facts, according to [redacted].

Discussion

Clearly, as the foregoing outline of legal authorities indicates, how a taxpayer treats [redacted] development expenditures, i.e., current deduction or capitalization/ amortization, is considered to be a method of accounting. Similarly, a change to/from current deduction from/to capitalization/amortization of [redacted] development expenditures is a change in method of accounting. Rev. Rul. 71-248, 1971-1 C.B. 55. [redacted] does not contend otherwise.

Example 3 of Treas. Reg. Sec. 1.446-1(e)(2)(iii) sets forth an example of a "change in underlying facts" situation which results in a different treatment of an expense item under the same method of accounting. In that example, the taxpayer is an accrual basis taxpayer that maintains a vacation pay plan. The taxpayer does not claim a deduction for vacation pay until the year it is actually paid because it did not have a completely vested vacation pay plan, and therefore, the liability for payment did not accrue until that year. The taxpayer subsequently adopted a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment arises. The example holds that the change of the year of deduction is not a change in method but results instead because of a change in underlying facts.

In the case of Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), the taxpayer, an accrual basis taxpayer, was engaged in the publishing of various specialized publications. The bulk of its gross income was derived from the sale of advertising space in the publications. Orders for the purchase of advertising space were solicited several months in advance of the proposed publication dates and were noncancellable. All orders not previously paid for were billed on the closing date which for 1960, 1961, 1962, and 1963 was in the latter part (approximately November) of the calendar year preceding the year of publication. In connection with its 1964 publications, Decision instituted a change in its contract terms which changed the billing date to January of 1964. As a result of the new contract terms there were no billings for these publications prior to January 1, 1964, even though orders were solicited throughout most of 1963. In holding for the taxpayer that the change in billing procedure was not a change in method of accounting the court stated:

> [a]lthough the change had consequences in the annual determination of income, such consequences were not produced by the accounting system. In essence this kind of business policy change was no different from a decision to lower prices or halt production for a year. ... Petitioner merely agreed with its customers not to bill on the 1963 orders until 1964 for advertising in its 1964 publications.

Decision, Inc., 47 T.C. at page 64.

Briefly stated, we understand [redacted]'s "change of underlying facts" argument to be that beginning in [redacted] [redacted] undertook a series of major [redacted] development projects, which required it to spend substantially greater amounts than it had prior to [redacted] on [redacted] development. [redacted] argues that this expansion was motivated by [redacted]'s change in business strategy.

In both Decision and Example 3 of Treas. Reg. Sec. 1.446-1(e)(2)(iii), it is clear how the "changed facts" lead to a different treatment of the item under the existing method of accounting. Such is not the case, however, with respect to "changed facts" alleged by [redacted] and the method of accounting which [redacted] employed prior to [redacted]. There is no question that [redacted]'s method of accounting for [redacted] costs prior to [redacted] was to capitalize/amortize such costs. We fail to see how simply undertaking more [redacted] projects and spending more on [redacted] development beginning in [redacted] would entitle [redacted] to expense [redacted] costs as incurred under the method of accounting that existed prior to [redacted].

Alternatively, [redacted]'s "changed facts" argument may be that the [redacted] development activity undertaken by [redacted] beginning in [redacted] was so fundamentally different from that undertaken prior to [redacted] so as to constitute a new "item" for tax accounting purposes and, as such, [redacted] was free to select a method of accounting for this new item in [redacted]. In Federated Department Stores, Inc. v. Commissioner, 51 T.C. 500 (1968), the Tax Court provided the following as a guide in determining whether a taxpayer had changed its method of accounting:

> Fundamentally, the item itself must be basically the same as an item previously accounted for with the present method of accounting differing from the prior treatment. Unless the transactions are basically the same, the accounting treatment would not be same but only a "new" accounting method for a different transaction.

Federated Department Stores, 51 T.C. at 513, 514. However, the alleged "changed facts" are merely that, beginning in [redacted], [redacted] made a business decision to undertake a greater number of "major" [redacted] development projects and spent substantially more on such projects, as compared to [redacted]. Admittedly, we found no cases in which a court ruled directly on whether an increase in expenditures with respect to a particular item constitutes a a "change in underlying facts." We are, nonetheless, confident that it does not.

We believe that there was a "fundamental equivalence" between [redacted] projects undertaken before [redacted] and after [redacted]. It is reasonable to presume that in addition to "major" [redacted] projects undertaken after [redacted], [redacted] continued to undertake and incur costs for "minor" [redacted] projects which were equivalent to those for projects undertaken prior to [redacted]. However, [redacted] apparently expensed these "minor" projects in [redacted] as well. By definition, there were no "changed facts" with respect to these "minor" projects and therefore they could not have been considered a new item for tax accounting purposes in [redacted]. Thus, [redacted] clearly changed its method of accounting in [redacted] for these "minor" projects.

Additionally, [redacted] appears to admit to at least one instance of a "major" pre-[redacted] [redacted] project, i.e., the [redacted] project, which of course presumably was capitalized/amortized under its method of accounting prior to [redacted]. Given this, there appears to be "fundamental equivalence" between the pre-[redacted] and post-[redacted] vis-a-vis major [redacted] projects. As such, under the fundamental equivalence rule of Federated, the [redacted] "major" [redacted] projects would not constitute a new item for tax accounting purposes, and as such, [redacted] was not free to adopt a new method of accounting for the major [redacted] projects without first obtaining the consent of the Commissioner.

[redacted]'s decision to expense [redacted] development costs beginning in [redacted] may very likely have been motivated by its dramatic increase in [redacted] expenditures. However, the mere fact that it makes more sense "tax-wise" to take an immediate deduction for these expenditures rather than to spread the deduction over a period of years is not a "change of facts" for purposes of section 1.446-1(e)(2)(iii) of the regulations. Once a taxpayer makes an election of one, two, or more alternative methods of reporting income, he is not permitted to convert to another alternative method of his own volition when it later becomes evident that he has not chosen the most advantageous method. Pacific National Co. v. Welch, 304 U.S. 191 (1938).

If you have any questions regarding the foregoing, please contact Chris Fisher at (216) 522-3380.

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